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# Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction

Bradley W. Joondeph

*Santa Clara University School of Law*, [bjoondeph@scu.edu](mailto:bjoondeph@scu.edu)

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# RETHINKING THE ROLE OF THE DORMANT COMMERCE CLAUSE IN STATE TAX JURISDICTION

*Bradley W. Joondeph\**

I.	INTRODUCTION .....	109
II.	THE CURRENT STATE OF STATE TAX JURISDICTION.....	115
III.	RETHINKING SUBSTANTIVE JURISDICTION.....	122
IV.	RETHINKING ENFORCEMENT JURISDICTION.....	132
V.	CONCLUSION.....	139

## I. INTRODUCTION

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to impose sales or use taxes on goods purchased over the Internet.<sup>1</sup> Forty-five

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\* Associate Professor, Santa Clara University School of Law. I owe thanks to Vinita Bali, June Carbone, David Franklin, Walter Hellerstein, Jeff Kahn, Frank Katz, Kerry Macintosh, Gary Neustadter, Margaret Russell, Gary Spitko, Sri Srinivasan, Srija Srinivasan, and John Swain for their assistance and comments on previous drafts. Thanks also to the participants in a works-in-progress forum at Santa Clara University School of Law for their valuable insights.

<sup>1</sup> For a small sample of the academic discussion, see David T. Brown, *No Easy Solutions in the Sales Tax on E-Commerce Debate: Lessons from the Advisory Commission on Electronic Commerce Report to Congress*, 27 J. CORP. L. 117 (2001); Arthur J. Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet Is Changing Tax Laws*, 34 CONN. L. REV. 333 (2002); Walter Hellerstein, *Deconstructing the Debate over State Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 549 (2000); Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425 (1997); Kendall L. Houghton & Walter Hellerstein, *State Taxation of Electronic Commerce: Perspectives on Proposals for Change and Their*

states currently impose general retail sales and use taxes on most tangible goods that are purchased or used within their borders.<sup>2</sup> Together, these taxes impose a one-time exaction on most goods ultimately consumed within the taxing state, regardless of the seller's location. Sales and use taxes are vital to the states' present fiscal health, accounting for 33 percent of state tax revenue nationwide<sup>3</sup> and more than \$183 billion annually.<sup>4</sup>

But sales consummated over the Internet—more broadly, sales consummated with out-of-state sellers through whatever means—have contributed to a substantial and growing gap in the sales and use tax structure.<sup>5</sup> Under prevailing constitutional law, states lack jurisdiction to require out-of-state vendors to collect a sales or use tax when the vendor has no “physical presence” in the taxing state.<sup>6</sup> For example, suppose a California resident purchases a book from Amazon.com, Inc. through its web site. The purchaser's use of that book in California is subject to California's use tax, but the only practical means for the state to enforce the tax is to have Amazon.com collect the levy at the time of sale. Because Amazon.com has no physical presence in California, however—it neither owns nor rents property in the state, hires no employees or independent contractors there, and

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*Constitutionality*, 2000 BYU L. REV. 9 (2000); Michael Mazerov & Iris J. Lav, *Problems with a 'Moratorium' on Internet Commerce Taxation*, 14 ST. TAX NOTES 1697 (1998); Michael J. McIntyre, *Taxing Electronic Commerce Fairly and Efficiently*, 52 TAX L. REV. 625 (1997); Charles E. McLure, Jr., *Sales and Use Taxes on Electronic Commerce: Legal, Economic, Administrative, and Political Issues*, 34 URB. LAW. 487 (2002); Robert D. Plattner, Quill: *Ten Years After*, 25 ST. TAX NOTES 1017, 1020–21 (2002); Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1*, 11 ST. TAX NOTES 177 (1996); John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419 (2002); Dennis Zimmerman, *The Internet Sales Tax Debate: Sorting Through the Economic Issues*, 22 ST. TAX NOTES 1001, 1001 (2001).

<sup>2</sup> DAVID BRUNORI, *STATE TAX POLICY: A POLITICAL PERSPECTIVE* 67 (2001); 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶ 12.02 (3d ed. 2002).

<sup>3</sup> U.S. CENSUS BUREAU, *STATE GOVERNMENT TAX COLLECTIONS: 2002* (2003), available at <http://www.census.gov/govs/statetax/0200usstax.html>.

<sup>4</sup> John L. Mikesell, *State Retail Sales Taxes, 1999-2001: The Recession Hits*, 27 ST. TAX NOTES 489, 489 (2003).

<sup>5</sup> See BRUNORI, *supra* note 2, at 75–76; Charles E. McLure, Jr., *Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World*, 14 ST. TAX NOTES 1169, 1176–77 (1998).

<sup>6</sup> See *Quill Corp. v. North Dakota*, 504 U.S. 298, 309–19 (1992); 2 HELLERSTEIN & HELLERSTEIN, *supra* note 2, at ¶ 19.02[3][c].

delivers all of its merchandise into the state through common carriers—California is constitutionally prohibited from requiring Amazon.com to collect the tax. Absent the unlikely event of the purchaser voluntarily remitting the tax to California,<sup>7</sup> the purchase completely escapes sales or use taxation. It is estimated that this hole in the sales and use tax system cost the states nearly \$11 billion in revenue in 2003.<sup>8</sup>

The constitutional basis for this jurisdictional rule, according to the Supreme Court, is the dormant Commerce Clause. The Due Process Clause of the Fourteenth Amendment also places limits on the states' jurisdiction to tax, limits that are very similar to those that restrain a state's adjudicative jurisdiction.<sup>9</sup> But the Commerce Clause demands something more—specifically, a “substantial nexus” between the taxing state and any activity or person that the state seeks to tax.<sup>10</sup> And the Court has concluded that, at least with respect to the obligation to collect use taxes, such a “substantial nexus” exists only when a person or firm is physically present in the taxing state.<sup>11</sup> (The Court has so far reserved the question whether this physical presence standard also applies to other tax obligations, such as remitting income tax.<sup>12</sup>) Without a physical presence requirement, the Court has reasoned, interstate sellers might be subjected to use tax collection obligations in every state in which they have customers, despite having only minimal contacts with those jurisdictions, and collectively these compliance obligations would impose an “undue burden” on interstate commerce.<sup>13</sup>

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<sup>7</sup> See William F. Fox & LeAnn Luna, *Subnational Taxing Options: Which Is Preferred, a Retail Sales Tax or VAT?*, 27 ST. TAX NOTES 875, 877 n.12 (2003) (describing use tax compliance by individuals through self-assessment as “nearly nonexistent”); Kirk J. Stark, *The Uneasy Case for Extending the Sales Tax to Services*, 29 ST. TAX NOTES 211, 216 & n.49 (2003); Tracey Kaplan, *State Seeks Bonus from Obscure Tax: Yacht Owner's Story Illustrates Assessment*, SAN JOSE MERCURY NEWS, July 26, 2003, available at <http://www.bayarea.com/mld/mercurynews/news/6390032.htm> (last visited July 28, 2003) (reporting that only 322 California residents voluntarily remitted use taxes in 2002, generating revenue of \$20,700, and that roughly \$1.24 billion in use taxes went unpaid in California in 2002).

<sup>8</sup> Zimmerman, *supra* note 1, at 1001.

<sup>9</sup> See *Quill*, 504 U.S. at 306–08.

<sup>10</sup> *Id.* at 311–13.

<sup>11</sup> *Id.*

<sup>12</sup> See John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 321–26 (2003).

<sup>13</sup> See *Quill*, 504 U.S. at 312–19 & n.6; *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 758–60 (1967).

This dormant Commerce Clause nexus requirement has been the subject of heated debate, especially in recent years. Many believe the “bright line” standard of physical presence settles expectations, reduces litigation, and properly reflects the principle that “a business should [not] have to pay tax to a jurisdiction unless that jurisdiction is providing benefits and protections to the business.”<sup>14</sup> They have advocated extending the physical presence standard to other levies, most notably corporate income taxes.<sup>15</sup> Others argue that the requirement of physical presence is arbitrary and anachronistic—“artificial through and through”<sup>16</sup>—and that it is “essentially a tool for tax avoidance.”<sup>17</sup> They contend that tax jurisdiction should instead be

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<sup>14</sup> Timothy Catts, *Sparks Fly over Business Activity Nexus at TEI Conference*, 27 ST. TAX NOTES 1161, 1161 (2003) (statement of Arthur R. Rosen, chair of the state and local tax practice at McDermott, Will & Emery).

<sup>15</sup> See, e.g., *id.*; Timothy Catts, *Federal Bill Would Link ‘Streamlining’ to Business Activity Tax*, 27 ST. TAX NOTES 371, 371 (2003). In July 2002, the House Judiciary Subcommittee on Commercial and Administrative Law approved the “Business Activity Modernization Act.” See Doug Sheppard, *2002 in the States: ‘Streamlining’ Quiet After the Internet Tax Storm*, 26 ST. TAX NOTES 906, 909 (2002). The bill provided, in relevant part, that

No State or subdivision thereof shall have power to impose, for any taxable year ending after the date of enactment of this title, a business activity tax on any person relating to such person’s activities that affect interstate commerce, unless such person has a substantial physical presence in such State or subdivision.

H.R. 2526, 107th Cong. § 101(a) (2002). The bill was not considered by the full House Judiciary Committee, however, and thus never reached the House floor. See Sheppard, *supra*, at 109. On October 1, 2003, Representatives Bob Goodlatte and Rick Boucher (both of Virginia) re-introduced legislation containing very similar language:

Except as otherwise provided by this Act, no taxing authority of a State shall have power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such person’s activities in interstate commerce, unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed.

H.R. 3220, 108th Cong. § 3(a) (2003). The bill was referred to the House Judiciary Committee, but as of late March 2004, no further action had been taken. See Kerrita McClaughlyn, *Surprise, Surprise: Business, Government Reps Clash on BAT Nexus*, 31 ST. TAX NOTES 980, 980 (2004).

<sup>16</sup> Plattner, *supra* note 1, at 1017.

<sup>17</sup> Dan Bucks & Frank Katz, *Explanation of the Multistate Tax Commission’s Proposed Factor Presence Nexus Standard*, 25 ST. TAX NOTES 1037, 1038 (2002); see also Charles E. McLure, Jr. & Walter Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 31 ST. TAX NOTES 721, 734–35

resolved on the more pragmatic basis of a firm's "economic presence" in the taxing state, such as the level of its sales, property, or payroll.<sup>18</sup> Regardless, everyone seems to agree that the dormant Commerce Clause imposes *some* jurisdictional requirements on state taxes; the dispute concerns the nature of the nexus that should be necessary.

To me, this debate about Commerce Clause nexus standards, while important in its own right, has overlooked a more foundational question. In my view, we need to examine not just what the dormant Commerce Clause should require in terms of state tax jurisdiction, but whether the clause speaks to the question at all.

Before setting out my argument in full, let me explain its basic points. As others have aptly explained, there are two distinct components of state tax jurisdiction: "substantive jurisdiction" and "enforcement jurisdiction."<sup>19</sup> Substantive jurisdiction concerns a state's jurisdiction over the value or activity that it seeks to tax—the income, the property, the sale, or the consumption, for example. Enforcement jurisdiction, in contrast, concerns a state's regulatory authority over the person or entity that it requires to pay or to collect the tax.<sup>20</sup> The Supreme Court has long interpreted the dormant Commerce Clause to require that a taxing state have both substantive and enforcement jurisdiction—that it have a sufficient nexus with both the value or activity it seeks to tax and the person or entity it seeks to pay or collect the tax.<sup>21</sup>

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(2004) (critiquing the justifications for extending the physical presence standard to business activity taxes); McLaughlyn, *supra* note 15, at 980 (reporting the view of Harley Duncan, executive director of the Federation of Tax Administrators, that a national physical presence standard for income taxes would bless "the use of all sorts of intangible holding companies" and "moving money around").

<sup>18</sup> See Bucks & Katz, *supra* note 17, at 1037; Swain, *supra* note 12, at 373–93. The Multistate Tax Commission (MTC), an organization formed by a majority of the states to promote uniformity and coordination in state taxation, has proposed a "factor presence" standard for determining state jurisdiction to impose business activity taxes, such as corporate income taxes. See Doug Sheppard, *MTC Approves Factor Presence Nexus Standard*, 26 ST. TAX NOTES 243 (2002). Under the MTC proposal, a state would have enforcement jurisdiction to impose a business activity tax on any firm with "(a) a dollar amount of \$50,000 of property; or (b) a dollar amount of \$50,000 of payroll; or (c) a dollar amount of \$500,000 of sales; or (d) 25 percent of total property, total payroll or total sales" in the taxing state. Multistate Tax Commission, *Factor Presence Nexus Standard*, 25 ST. TAX NOTES 1035, 1035 (2002).

<sup>19</sup> Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1, 3–4 (2003).

<sup>20</sup> One component of jurisdiction can exist without the other. See *infra* text accompanying notes 22–24.

<sup>21</sup> See *infra* notes 25–53 and accompanying text.

My thesis is that the attribution of these jurisdictional requirements to the dormant Commerce Clause is, at least in part, analytically confused and premised on some questionable empirical assumptions. First, the requirement of substantive jurisdiction is probably better conceived not as deriving from the dormant Commerce Clause, but as a manifestation of the broader constitutional prohibition on extraterritorial legislation. In our federal system, states generally can legislate only with respect to those activities that occur within their borders. This territorial limit on states' legislative jurisdiction is a basic, unstated premise of our constitutional structure. Thus, although states generally are prohibited from taxing values or activities occurring in other states, this restraint exists independent of the dormant Commerce Clause.

The matter of enforcement jurisdiction—a state's authority to impose tax compliance obligations on persons or entities engaged in interstate commerce—is more complicated. The Supreme Court has held that, without such a requirement, tax compliance obligations would impose an undue burden on interstate commerce. But it is unclear how much a firm's nexus with the taxing state actually affects the costs of complying with that state's tax laws. Once we disaggregate the factors influencing the economic burden of tax compliance, we find only two aspects of this burden that lend credence to a jurisdictional requirement: the costs associated with a firm's lack of familiarity with the state's tax laws, and the cost per event attributable to a firm having only a limited number of taxable events in the taxing state. Both sorts of costs would seem to increase as a firm's nexus with the taxing state decreased. But these are only two of several factors affecting the relevant burden on interstate commerce, the rest of which are generally unrelated to nexus. And the degree to which the relevant burden on interstate commerce actually turns on these two factors remains an unanswered empirical question. We therefore are left with a very uncertain basis for concluding that, for firms lacking a certain connection to the taxing state, the economic burden caused by tax compliance obligations is actually "undue."

Ultimately, then, the case for interpreting the dormant Commerce Clause to impose a nexus requirement with respect to state taxes is an uneasy one. To be sure, the Commerce Clause uncontroversially forbids states from discriminating against interstate commerce, and taxes imposed on firms that have no connection to the taxing state will often produce impermissible, discriminatory results. But it is unclear whether the Commerce Clause itself says anything about these

jurisdictional requirements. Indeed, the entire notion of Commerce Clause nexus may be misconceived.

## II. THE CURRENT STATE OF STATE TAX JURISDICTION

Again, there are two distinct aspects of state tax jurisdiction: substantive jurisdiction, which concerns a state's jurisdiction over the value or activity the state seeks to tax, and enforcement jurisdiction, which concerns a state's regulatory authority over the person on whom it seeks to impose a tax compliance obligation.<sup>22</sup> The two components operate independently, such that one can exist without the other. For example, when a Nevada resident purchases a new set of dinnerware from Crate and Barrel through the company's web site, Nevada has the substantive jurisdiction to impose a use tax on the purchaser's use or storage of the dinnerware in Nevada. But unless Crate and Barrel has a physical presence in Nevada (and it likely does not, as it has no retail stores there<sup>23</sup>), the state will lack the enforcement jurisdiction necessary to force Crate and Barrel to collect the use tax due on the dinnerware. Conversely, Nevada has the enforcement jurisdiction necessary to require each of its residents to pay a property tax on real estate they own. But Nevada lacks the substantive jurisdiction necessary to impose that property tax on real estate that is located outside the state.<sup>24</sup> The state would have jurisdiction over the taxpayer, but it would lack jurisdiction over the value being taxed.

With respect to substantive jurisdiction, the Supreme Court appears to have first interpreted the Commerce Clause as imposing this constraint on the states' taxing authority in the 1870s.<sup>25</sup> In the 1872 case of *Morgan v. Parham*, the Court invalidated an Alabama property tax assessed on a ship that had visited the Port of Mobile but was domiciled in New York City.<sup>26</sup> Under the prevailing "home port doctrine," the law deemed a ship to have its tax situs exclusively in its

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<sup>22</sup> Hellerstein, *supra* note 19, at 3–4.

<sup>23</sup> See <http://www.crateandbarrel.com/locator/listing.asp> (last visited Feb. 29, 2004).

<sup>24</sup> See, e.g., *Norfolk & W. Ry. Co. v. Mo. State Tax Comm'n*, 390 U.S. 317, 325 (1968) ("The taxation of property not located in the taxing State is constitutionally invalid.").

<sup>25</sup> See, e.g., *Fargo v. Hart*, 193 U.S. 490 (1904); *Morgan v. Parham*, 83 U.S. (16 Wall.) 471 (1872).

<sup>26</sup> 83 U.S. (16 Wall.) 471 (1872).



state of domicile.<sup>27</sup> As the ship had only been in Mobile temporarily, the Court held that “the State of Alabama had no jurisdiction over this vessel for the purpose of taxation,”<sup>28</sup> and that Alabama’s attempt to impose the tax therefore constituted “an interference with the commerce of the country not permitted to the States.”<sup>29</sup>

Since *Morgan v. Parham*, the substantive jurisdiction requirement has remained an important aspect of the Court’s state and local tax jurisprudence. It is presently embodied in the first prong of the Supreme Court’s four-part test for assessing state taxes under the dormant Commerce Clause, first articulated in *Complete Auto Transit, Inc. v. Brady*.<sup>30</sup> In *Complete Auto*, the Court jettisoned a longstanding, formalistic rule that states could not impose “taxes upon the privilege of carrying on a business that was *exclusively* interstate in character,”<sup>31</sup> instead reasoning that state taxes should be judged based on their “practical effect” and “economic realities.”<sup>32</sup> The Court thus held that a state tax will satisfy the Commerce Clause when it meets four criteria: “the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services

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<sup>27</sup> See, e.g., *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 441–44 (1979) (discussing the substance and history of the home port doctrine); 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶ 4.12[2][c] (3d ed. 2002).

<sup>28</sup> *Morgan*, 83 U.S. (16 Wall.) at 476.

<sup>29</sup> *Id.* at 479. Similarly, the Court held that Indiana’s attempt to tax property beyond its jurisdiction violated the Commerce Clause in the 1904 decision of *Fargo v. Hart*, 193 U.S. 490 (1904). The taxpayer was an express company domiciled in New York and doing business in several states, including Indiana. *Id.* at 495–96. Indiana used the apportionment method to determine the value of the taxpayer’s property located in the state—that is, it multiplied the value of *all* of the taxpayer’s property, wherever located, by a fraction that reflected the percentage of the taxpayer’s property located in Indiana. *Id.* at 496. The taxpayer did not dispute the use of apportionment generally, but it contested the inclusion in the apportionable base of \$15 million in bonds that it held at its New York offices. The Court upheld the taxpayer’s claim, finding that there was not the necessary “organic connection” between the bonds and the taxpayer’s property in Indiana that would justify their inclusion in the apportionable base. *Id.* at 499–501. According to Justice Holmes, Indiana had “attempt[ed] to tax property beyond the jurisdiction of the State,” and thus had imposed “an unconstitutional burden on commerce among the States.” *Id.* at 502.

<sup>30</sup> 430 U.S. 274 (1977).

<sup>31</sup> *Spector Motor Service v. O’Connor*, 340 U.S. 602, 609 (1951) (emphasis in original), *overruled by* *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

<sup>32</sup> *Complete Auto*, 430 U.S. at 278–79.

provided.”<sup>33</sup>

The Court has invoked this four-part test in addressing virtually every dormant Commerce Clause challenge to a state or local state tax since *Complete Auto* was decided in 1977, and it has invalidated state taxes when the state lacked a “substantial nexus” with the value it sought to tax.<sup>34</sup> For example, at issue in *Allied-Signal, Inc. v. Director, Division of Taxation* was whether New Jersey could tax an apportioned share of an out-of-state corporation’s gain on the sale of stock it had held in an unrelated business.<sup>35</sup> Because of the difficulty in tracing income earned by an interstate business to its specific geographic source through separate accounting,<sup>36</sup> states (including New Jersey) have long used the formulary apportionment method to determine the amount of income earned by multistate corporations within their borders.<sup>37</sup> Under formulary apportionment, all income earned by a taxpayer in the operation of its unitary business is included in the taxpayer’s apportionable tax base. That base is then multiplied by a percentage determined by a statutory formula, a formula that is designed to reflect the portion of the taxpayer’s economic activity occurring in the taxing state.<sup>38</sup>

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<sup>33</sup> *Id.* (emphasis added).

<sup>34</sup> See, e.g., *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 183 (1995); *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 310–11 (1994); *Itel Containers Int’l Corp. v. Huddleston*, 507 U.S. 60, 73 (1993); *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992); *Trinova Corp. v. Mich. Dep’t of Treasury*, 498 U.S. 358, 372 (1991); *Amerada Hess Corp. v. Dir., Div. of Taxation*, 490 U.S. 66, 72–73 (1989); *Goldberg v. Sweet*, 488 U.S. 252, 257–60 (1989); *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 30 (1988); *Am. Trucking Ass’n, Inc. v. Scheiner*, 483 U.S. 266, 291 (1987); *Wardair Can., Inc. v. Fla. Dep’t of Revenue*, 477 U.S. 1, 8 (1986); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 617 (1981); *Maryland v. Louisiana*, 451 U.S. 725, 754 (1981); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 443 (1980); *Dep’t of Revenue v. Ass’n of Wash. Stevedoring Cos.*, 435 U.S. 734, 745–46 (1978); see also Walter Hellerstein, Michael J. McIntyre & Richard D. Pomp, *Commerce Clause Restraints on State Taxation After Jefferson Lines*, 51 TAX L. REV. 47, 49 & n.13 (1995).

<sup>35</sup> 504 U.S. 768, 722–77 (1992).

<sup>36</sup> See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 469–70 (7th ed. 2001); see also *Mobil Oil*, 445 U.S. at 438 (“[S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale.”).

<sup>37</sup> See *Butler Bros. v. McColgan*, 315 U.S. 501, 508–09 (1942) (holding that the taxpayer’s separate accounting evidence did nothing to “impeach the validity or propriety” of the state’s method of formulary apportionment).

<sup>38</sup> See Bradley W. Joondeph, *The Meaning of Fair Apportionment and the*

An important constitutional limit on the states' use of the apportionment method is the "unitary business principle": a state can only include in a taxpayer's apportionable tax base income that the taxpayer has earned in the course of the unitary business that it carries on in part in the taxing state.<sup>39</sup> Without such an "organic connection" between the taxing state and the income it seeks to apportion, the state would lack jurisdiction to tax any portion of that income; the essential justification for looking beyond the state's borders to determine the income earned in the taxing state would be lost.<sup>40</sup> Because the Court in *Allied-Signal* determined that the taxpayer's gain derived from business activity unrelated to the taxpayer's business in New Jersey, the income could not "in fairness be attributed to the taxpayer's activities within the taxing State."<sup>41</sup> That is, New Jersey lacked a "substantial nexus" with the value it sought to tax, rendering the levy invalid under the dormant Commerce Clause.

Less obviously—but perhaps redundantly—the requirement of substantive tax jurisdiction also finds expression in the "fair apportionment" prong of the *Complete Auto* test.<sup>42</sup> A fairly apportioned tax will, by definition, only reach those values that are reasonably attributable to the taxing state. When a state imposes a fairly apportioned income tax on a multistate business, for example, the state only taxes that income that one can reasonably say was earned in the taxing state. Of course, another important purpose of the fair apportionment requirement is to prevent multiple states from taxing the same value, thereby disadvantaging interstate commerce.<sup>43</sup> But as Walter Hellerstein has explained, "[w]holly apart from its role in preventing multiple taxation, the fair apportionment criterion serves to limit the territorial reach of state power by requiring that the state's tax base corresponds to the taxpayer's in-state presence."<sup>44</sup>

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*Prohibition on Extraterritorial State Taxation*, 71 FORDHAM L. REV. 149, 155–56 (2002).

<sup>39</sup> See, e.g., *Allied-Signal*, 504 U.S. at 778–88; *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 316–20 (1982); *Exxon Corp. v. Wis. Dep't of Revenue*, 447 U.S. 207, 223–24 (1980); *Mobil Oil*, 445 U.S. at 438–40; 1 HELLERSTEIN & HELLERSTEIN, *supra* note 27, ¶ 8.07.

<sup>40</sup> 1 HELLERSTEIN & HELLERSTEIN, *supra* note 27, ¶ 8.07[1].

<sup>41</sup> *Allied-Signal*, 504 U.S. at 780.

<sup>42</sup> See Joondeph, *supra* note 38, at 158.

<sup>43</sup> *Id.* at 156–58.

<sup>44</sup> Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 MICH. L. REV. 138, 186 (1988); see also James H. Peters, *Sales/Use Taxes: Is Fair Apportionment a Proper Test?*, 6 ST. TAX NOTES 105, 105 (1994).

Thus, as the Court has recognized, an essential aspect of the fair apportionment inquiry is whether there exists an “economic justification for the State’s claim upon the value taxed, to discover whether a State’s tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State.”<sup>45</sup>

With respect to enforcement jurisdiction, the Court first seems to have associated the dormant Commerce Clause with the requirement that states have a certain nexus with the persons on whom they impose tax compliance obligations in the late 1930s. For instance, the 1939 case of *Felt & Tarrant Manufacturing Co. v. Gallagher* involved California’s attempt to require an Illinois corporation to collect a use tax on its sales to California residents.<sup>46</sup> The Illinois company argued that, although it had employed selling agents in California, it had “carried on no intrastate operations” in the state and thus was “not subject to its jurisdiction.”<sup>47</sup> The Court disagreed, holding that the tax collection obligation did not amount to a “direct burden upon interstate commerce prohibited by the Federal Constitution.”<sup>48</sup> Nonetheless, the opinion entertained the argument that a state’s lack of jurisdiction with the collector of a tax could render the tax impermissible under the Commerce Clause.<sup>49</sup>

Under current doctrine, the requirement of enforcement jurisdiction is represented in the first prong of the *Complete Auto* test. A state must have a “substantial nexus” with any person or entity on which it seeks to impose a tax compliance obligation, just as it must

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<sup>45</sup> Okla. Tax Comm’n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

<sup>46</sup> 306 U.S. 62 (1939).

<sup>47</sup> *Id.* at 66.

<sup>48</sup> *Id.*

<sup>49</sup> Two years later, in the companion cases of *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941), and *Nelson v. Montgomery Ward & Co.*, 312 U.S. 373 (1941), the Court similarly considered—but ultimately rejected—Commerce Clause challenges to Iowa’s requirement that out-of-state sellers collect use taxes on their mail-order sales to Iowa customers. Sears and Montgomery Ward both maintained retail stores in Iowa, but they also sold merchandise through mail orders, shipping the merchandise from outside the state directly to customers via common carriers. *Sears*, 312 U.S. at 362; *Montgomery Ward*, 312 U.S. at 373–74. The Court held that Iowa’s demand that the retailers collect use taxes on their mail-order sales was consistent with the Commerce Clause; the presence of their stores in the state provided a sufficient nexus for Iowa to “exact this burden as a price of enjoying the full benefits flowing from [their] Iowa business.” *Sears*, 312 U.S. at 364. Despite rejecting the argument, though, the Court again considered the possibility that a tax compliance obligation might constitute an impermissible “burden upon interstate commerce” due to the state’s lack of enforcement jurisdiction. *Id.* at 365.

have the same nexus with any value or activity it seeks to tax.<sup>50</sup> The pivotal recent case is *Quill Corp. v. North Dakota*, where the Court invalidated North Dakota's attempt to require an out-of-state seller of office furniture to collect a use tax on its sales to North Dakota residents.<sup>51</sup> Quill had advertised in national periodicals that had been sent into North Dakota and had solicited business from North Dakota residents through other mailings and telephone calls.<sup>52</sup> But Quill neither owned nor rented any property in the state, nor did it employ any persons there.<sup>53</sup> Because Quill had no more than a *de minimis* physical presence in North Dakota, the Court held that the state lacked the "substantial nexus" necessary to require Quill to collect use taxes.<sup>54</sup> Although North Dakota clearly had jurisdiction over the value it sought to tax—the use of the furniture in North Dakota—imposing a compliance obligation on Quill violated the dormant Commerce Clause.

It is important to bear in mind that these jurisdictional limits on the states' taxing powers are not grounded exclusively in the dormant Commerce Clause. For more than a century, the Court has also understood the Due Process Clause of the Fourteenth Amendment to prohibit a state from taxing interstate activities "unless there is a minimal connection or nexus between the interstate activities and the taxing State."<sup>55</sup> As under the Commerce Clause, this due process nexus requirement entails both substantive jurisdiction and enforcement jurisdiction. Thus, the Court has invalidated numerous state taxes under the Due Process Clause on the ground that the state lacked a sufficient connection with the value or activity that it sought to tax. *ASARCO, Inc. v. Idaho State Tax Commission*,<sup>56</sup> *F.W. Woolworth Co. v. Taxation and Revenue Department*,<sup>57</sup> and *Standard Oil v. Peck*<sup>58</sup> are a few examples. Likewise, the Court has struck down state tax compliance obligations on due process grounds when the state lacked a sufficient nexus with the firm required to collect the tax. This was the case in *National Bellas Hess, Inc. v. Department of*

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<sup>50</sup> See 1 HELLERSTEIN & HELLERSTEIN, *supra* note 27, ¶ 6.01.

<sup>51</sup> 504 U.S. 298 (1992).

<sup>52</sup> *Id.* at 302.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.* at 312–19.

<sup>55</sup> *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 464 (2000) (internal quotations omitted).

<sup>56</sup> 458 U.S. 307 (1982).

<sup>57</sup> 458 U.S. 354 (1982).

<sup>58</sup> 342 U.S. 382 (1952).

*Revenue*,<sup>59</sup> in which the Court invalidated the tax scheme at issue on both Commerce Clause and due process grounds, and in *Miller Bros. v. Maryland*.<sup>60</sup>

Still, the nexus requirements of the dormant Commerce Clause exist independently of those imposed by the Due Process Clause. Indeed, because of the distinct purposes of the two clauses, the Court has held that their jurisdictional requirements differ in content, at least in some circumstances.<sup>61</sup> The Due Process Clause, the Court has explained, “centrally concerns the fundamental fairness of government activity,” such that “‘notice’ or ‘fair warning’ [is] the analytic touchstone of due process nexus analysis.”<sup>62</sup> Thus, with respect to enforcement jurisdiction, a tax compliance obligation will satisfy due process when the company “purposefully direct[s] its activities” at the taxing state through the “continuous and widespread solicitation of business” in that state.<sup>63</sup>

In contrast, the dormant Commerce Clause “and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.”<sup>64</sup> Consequently, as discussed above, the Commerce Clause requires that a firm have a physical presence in the taxing state before a state can impose a tax compliance obligation on that firm, at least with respect to the duty to collect use taxes.<sup>65</sup> This physical presence standard is more rigorous than the “purposeful availment” standard imposed by the Due Process Clause. As the Court has explained, “a corporation may have the ‘minimum contacts’ with a taxing State as required by the Due Process Clause, and yet lack the ‘substantial nexus’ with that State as required by the Commerce Clause.”<sup>66</sup> Thus, in *Quill*, although North

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<sup>59</sup> 386 U.S. 753 (1967). The Court subsequently overruled this aspect of *National Bellas Hess* in *Quill*, holding that there is no due process problem when the firm has purposefully directed its activities at the taxing state, even though the firm lacks a physical presence in the taxing state. *Quill Corp. v. North Dakota*, 504 U.S. 298, 307–08 (1992). Nonetheless, the larger point still holds: the Due Process Clause imposes jurisdictional limits on the states’ authority to tax that exist independent of those mandated by the dormant Commerce Clause.

<sup>60</sup> 347 U.S. 340 (1954).

<sup>61</sup> See 1 HELLERSTEIN & HELLERSTEIN, *supra* note 27, ¶ 6.02.

<sup>62</sup> *Quill*, 504 U.S. at 312.

<sup>63</sup> *Id.* at 308.

<sup>64</sup> *Id.* at 312.

<sup>65</sup> See *supra* notes 53–54 and accompanying text.

<sup>66</sup> *Id.* at 313.

Dakota's imposition of a use tax collection duty on Quill was consistent with due process, the Court held that it nonetheless violated the dormant Commerce Clause.

As a descriptive matter, each of these points of law is well settled. The dormant Commerce Clause and the Due Process Clause both require that states have substantive and enforcement jurisdiction. These jurisdictional requirements operate independently and at times differ in content. Although there has been significant disagreement in recent years as to the appropriate breadth of state tax jurisdiction, the controversy has generally concerned the substance of the dormant Commerce Clause's "substantial nexus" requirement. To me, though, this debate has missed a more fundamental problem. It is possible that the ascription of *any* nexus requirements to the dormant Commerce Clause—whether as a matter of substantive jurisdiction or enforcement jurisdiction—is mistaken, and that the prevailing approach to these questions has muddled our understanding of the constitutional limits on the states' taxing authority. It is to these points that I now turn.

### III. RETHINKING SUBSTANTIVE JURISDICTION

The central purpose of requiring states to have a sufficient nexus with the activities or values that they seek to tax is to prohibit states from engaging in extraterritorial taxation. That is, the requirement of substantive tax jurisdiction—whatever its constitutional underpinnings—ensures that the states only tax those values attributable to activities occurring within their borders. This prohibition on extraterritorial taxes is a foundational principle of state taxation, a limit on state authority that has been recognized by the Supreme Court since the mid-1800s.<sup>67</sup> As the Court has frequently

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<sup>67</sup> See, e.g., *Case of the State Tax on Foreign-held Bonds*, 82 U.S. (15 Wall.) 300 (1872); *R.R. v. Jackson*, 74 U.S. (7 Wall.) 262 (1868); *Hays v. Pac. Mail S. S. Co.*, 58 U.S. (17 How.) 596 (1854). See also Paul J. Hartman, *State Taxation of Corporate Income from a Multistate Business*, 13 VAND. L. REV. 21, 31 n.31 (1959) (explaining that the Court "imposed territorial limitations on the power of a state to tax" even before the ratification of the Fourteenth Amendment).

It is important to note that not *all* extraterritorial state taxation is impermissible, although the Supreme Court has stated otherwise. See Joondeph, *supra* note 42, at 171–82. The Court's actual decisions demonstrate that where a state would face genuine administrative burdens in taxing a particular form of commerce without projecting its taxing authority beyond its borders, and the tax scheme at issue protects interstate commerce from discrimination, a state may tax commercial activity occurring in other states. See *id.*

reiterated, “a State may not tax value earned outside its borders.”<sup>68</sup> For instance, in the 1937 decision of *Great Atlantic & Pacific Tea Co. v. Grosjean*, the Court explained that a “state may not tax real property or tangible personal property lying outside her borders; nor may she lay an excise or privilege tax upon the exercise or enjoyment of a right or privilege in another state derived from the laws of that state and therein exercised and enjoyed.”<sup>69</sup> Or as Justice Stevens more recently summarized the idea, “[i]t is fundamental that a State has no power to impose a tax on income earned outside of the State.”<sup>70</sup>

Best understood, this prohibition on extraterritorial state taxation is really a manifestation of the broader constitutional prohibition on extraterritorial state legislation.<sup>71</sup> While the federal government has the authority to regulate conduct throughout the Nation, the legislative jurisdictions of the states are generally confined to those activities occurring within their borders.<sup>72</sup> As the Supreme Court concisely stated in the 1905 case of *Union Refrigerator Transit Co. v. Kentucky*, “the operation of state laws [is] limited to persons and property within the boundaries of the State.”<sup>73</sup> Consider the Court’s

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<sup>68</sup> *ASARCO, Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 315 (1982); *see also* *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983); *Exxon Corp. v. Wis. Dep’t of Revenue*, 447 U.S. 207, 221 (1980); *McLeod v. J. E. Dilworth Co.*, 322 U.S. 327, 330 (1944); *Butler Bros. v. McCollgan*, 315 U.S. 501, 507 (1942); *Conn. Gen. Life Ins. v. Johnson*, 303 U.S. 77, 80–81 (1938); *Norfolk & W. Ry. Co. v. North Carolina*, 297 U.S. 682, 685–86 (1936).

<sup>69</sup> 301 U.S. 412, 424 (citations omitted).

<sup>70</sup> *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 451 (1980) (Stevens, J., dissenting).

<sup>71</sup> *See* Joondeph, *supra* note 42, at 173–74.

<sup>72</sup> *See e.g.*, *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 572–74 (1996); *Bigelow v. Virginia*, 421 U.S. 809, 822–24 (1975); *Broderick v. Rosner*, 294 U.S. 629, 642 (1935); *Home Ins. v. Dick*, 281 U.S. 397, 411 (1930); *Fid. & Deposit Co. v. Tafoya*, 270 U.S. 426, 436 (1926); *St. Louis Cotton Compress Co. v. Arkansas*, 260 U.S. 346, 347–349 (1922); *N.Y. Life Ins. v. Dodge*, 246 U.S. 357, 367–77 (1918); *W. Union Tel. Co. v. Brown*, 234 U.S. 542, 546–47 (1914); *N.Y. Life Ins. v. Head*, 234 U.S. 149, 161 (1914); *Allgeyer v. Louisiana*, 165 U.S. 578, 591 (1897); *Huntington v. Attrill*, 146 U.S. 657, 669 (1892); *Bonaparte v. Tax Court*, 104 U.S. 592 (1881); 1 LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* § 6–8, at 1074 (3d ed. 2000) (“the Court has articulated virtually a *per se* rule of invalidity for extraterritorial state regulations—i.e., laws which directly regulate out-of-state commerce, or laws whose operation is triggered by out-of-state events”).

<sup>73</sup> 199 U.S. 194, 204 (1905); *see also* *St. Louis Cotton Compress*, 260 U.S. at 349 (“the State may regulate the activities of foreign corporations within the State but it cannot regulate or interfere with what they do outside”); *Bonaparte*, 104 U.S. at 594



treatment in *New York Life Insurance v. Head* of an attempt by Missouri to regulate the terms of a life insurance contract, first signed in Missouri but subsequently amended in New York, involving a New Mexico beneficiary and a New York insurance company:

[W]e must consider . . . how far it was within the power of the State of Missouri to extend its authority into the State of New York, and there forbid the parties, one of whom was a citizen of New Mexico and the other a citizen of New York, from making such loan agreement in New York simply because it modified a contract originally made in Missouri. Such question, we think, admits of but one answer since it would be impossible to permit the statutes of Missouri to operate beyond the jurisdiction of that State and in the State of New York, and there destroy freedom of contract without throwing down the constitutional barriers by which all the States are restricted within the orbits of their lawful authority and upon the preservation of which the Government under the Constitution depends. This is so obviously the necessary result of the Constitution that it has rarely been called in question.<sup>74</sup>

Recently the Court has invoked this limit on states' legislative jurisdictions as a basis for invalidating punitive damage awards that were intended, at least in part, to punish defendants for conduct that had taken place in other states.<sup>75</sup> In the 1996 decision of *BMW of North America, Inc. v. Gore*, for instance, the Court struck down an award partly on the ground that it amounted to extraterritorial regulation.<sup>76</sup> The Court stated that "principles of state sovereignty and comity" prohibit states from punishing tortfeasors for activity that is lawful in other states<sup>77</sup> and that states cannot "impose sanctions on [a defendant] in order to deter conduct that is lawful in other jurisdictions."<sup>78</sup> In 2003, the Court overturned a punitive damages award in *State Farm Mutual Automobile Insurance v. Campbell* where the plaintiffs had attempted to use the lawsuit—and thus Utah law—

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("No State can legislate except with reference to its own jurisdiction.").

<sup>74</sup> 234 U.S. 149, 161 (1914).

<sup>75</sup> See Seth F. Kreimer, *Lines in the Sand: The Importance of Borders in American Federalism*, 150 U. PA. L. REV. 973, 992–93 (2002).

<sup>76</sup> 517 U.S. 559 (1996).

<sup>77</sup> *Id.* at 572.

<sup>78</sup> *Id.* at 573.

"to expose, and punish, the perceived deficiencies of State Farm's operations throughout the country."<sup>79</sup> This, the Court held, was beyond the state's "legitimate concern."<sup>80</sup> "A basic principle of federalism is that each State may make its own reasoned judgment about what is permitted or proscribed within its borders, and each State alone can determine what measures of punishment, if any, to impose on a defendant who acts within its jurisdiction."<sup>81</sup>

To be sure, the precise contours of this prohibition on extraterritorial state legislation are not particularly well defined or understood.<sup>82</sup> For instance, there is substantial disagreement about the power of states to regulate the conduct of their own citizens when they are visiting other states.<sup>83</sup> (The Court's opinion in *Bigelow v. Virginia*,<sup>84</sup> as well as its recent citation to *Bigelow*'s relevant language with approval,<sup>85</sup> however, suggests that states lack such authority

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<sup>79</sup> 123 S. Ct. 1513, 1521 (2003).

<sup>80</sup> *Id.* at 1522.

<sup>81</sup> *Id.* at 1523.

<sup>82</sup> See Jack L. Goldsmith & Alan O. Sykes, *The Internet and the Dormant Commerce Clause*, 110 YALE L.J. 785, 789 (2001) ("The scope of the extraterritoriality principle is unclear."); Donald H. Regan, *Siamese Essays: (I) CTS Corp. v. Dynamics Corp. of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation*, 85 MICH. L. REV. 1865, 1884 (1987) (noting that "we do not understand the extraterritoriality principle (the principle that states may not legislate extraterritorially) nearly as well as we should").

<sup>83</sup> Compare Mark D. Rosen, *Extraterritoriality and Political Heterogeneity in American Federalism*, 150 U. PA. L. REV. 855, 862 (2002) (arguing that "states can take reasonable steps, including extraterritorial regulation, to ensure the efficacy of heterogeneous policies that themselves are not unconstitutional"), and Regan, *supra* note 82, at 1908 ("Why should we *not* think of a state as having an interest in its citizens which justifies regulation of their conduct wherever they may be?"), with John Hart Ely, *Choice of Law and the State's Interest in Protecting Its Own*, 23 WM. & MARY L. REV. 173, 192 (1981) ("[I]sn't there something somehow out of accord with at least our 'small c constitution'—out of accord in particular with the reasons we as a nation decided to supercede the Articles of Confederation—in adopting what amounts to a system of 'personal law' wherein people carry their home states' legal regimes around with them?"), and Kreimer, *supra* note 75, at 1017 (arguing that "the text, history, structure, and practice of American federalism . . . weigh heavily against the extraterritorial assertion of moralism to punish actions that take place on the soil of and with the permission of sister states").

<sup>84</sup> 421 U.S. 809 (1975).

<sup>85</sup> See *State Farm*, 123 S. Ct. at 1522 (parenthetically quoting *Bigelow* for the proposition that "[a] State does not acquire power or supervision over the internal affairs of another State merely because the welfare and health of its own citizens may be affected when they travel to that State"); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 571 n.16 (1996) (quoting same language).

under current law.) Moreover, it is unclear precisely under what circumstances cross-border effects can justify the regulation of out-of-state conduct. Nuisance law, product liability statutes, and municipal obscenity ordinances, for instance, have traditionally regulated local effects in a manner that necessarily affects behavior in other states.<sup>86</sup> At the same time, California surely could not ban the manufacturing of cigarettes in Kentucky based on the adverse health consequences to Californians from their smoking cigarettes in California.<sup>87</sup> These complications are unimportant to the present discussion, however. For our purposes, it suffices that, no matter what the extraterritoriality principle provides in fine detail, states' legislative jurisdictions are generally delimited by their geographic territories.

Given the Supreme Court's view that the dormant Commerce Clause imposes a substantive jurisdictional requirement on state taxing authority, it is unsurprising that the Court has also held that the Commerce Clause forbids extraterritorial state legislation more generally. Indeed, the Court has long held that "a state law that has the 'practical effect' of regulating commerce occurring wholly outside that State's borders is invalid under the Commerce Clause."<sup>88</sup> For example, consider the Court's 1935 decision in *Baldwin v. G. A. F. Seelig, Inc.*, which invalidated a New York law that prohibited the sale in New York of milk that had been purchased from out-of-state milk producers at a price lower than the minimum price for New York-produced milk.<sup>89</sup> In holding that the law violated the dormant Commerce Clause, the Court specifically alluded to its extraterritorial reach: "New York has no power to project its legislation into Vermont by regulating the price to be paid in that state for milk acquired there."<sup>90</sup> Similarly, the Court in *Brown-Forman Distillers Corp. v. New York State Liquor Authority*<sup>91</sup> and in *Healy v. Beer Institute, Inc.*<sup>92</sup> invoked the dormant Commerce Clause to invalidate state liquor price-affirmation statutes that had the practical effect of regulating the prices at which liquor could be sold in other states. As the Court stated in *Healy*, "the 'Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the

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<sup>86</sup> See Goldsmith & Sykes, *supra* note 83, at 795–96.

<sup>87</sup> See Regan, *supra* note 82, at 1899–1900.

<sup>88</sup> *Healy v. Beer Inst., Inc.*, 491 U.S. 324, 332 (1989).

<sup>89</sup> 294 U.S. 511 (1935).

<sup>90</sup> *Id.* at 521.

<sup>91</sup> 476 U.S. 573 (1986).

<sup>92</sup> 491 U.S. 324 (1989).

State.”<sup>93</sup>

On reflection, though, it seems that the unconstitutionality of laws like those at issue in *Seelig*, *Brown-Forman*, and *Healy*—laws that effectively regulate commercial activity in other states—should not depend on the Commerce Clause. As Donald Regan has argued, “extraterritoriality is not in essence a commerce clause problem.”<sup>94</sup> Rather, state laws that attempt to regulate conduct occurring in other states are unconstitutional *regardless of their impact on interstate commerce*. Imagine a hypothetical state law concerning gay civil unions (an example I borrow largely from Professor Regan).<sup>95</sup> Such unions are presently recognized in Vermont<sup>96</sup> (and perhaps soon in Massachusetts<sup>97</sup>) but generally no place else.<sup>98</sup> And under current law, states have no obligation to make civil unions available to their gay citizens, even though their laws permit and recognize marriages between heterosexual couples. Suppose that Nebraska enacted a law that prohibited any person from participating in a gay civil union ceremony, no matter where that ceremony took place. And suppose that a gay Vermont couple, previously joined by a civil union in their home state, was arrested while traveling in Omaha and prosecuted by Nebraska authorities for having participated in a gay civil union ceremony.

It seems obvious that the Nebraska law would be unconstitutional.<sup>99</sup> Nebraska lacks the authority to regulate the behavior of Vermont citizens that takes place in Vermont, no matter how morally objectionable that behavior might be to Nebraskans. Yet Nebraska’s law does not regulate commercial activity, interstate or otherwise. Indeed, the reasons often conjured as to why the law is unconstitutional have nothing to do with commerce. The problem is

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<sup>93</sup> *Id.* at 336 (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 642–43 (1982) (plurality opinion)). See also *Pharm. Research and Mfrs. v. Maine Dep’t of Human Servs.*, 123 S. Ct. 1855, 1870–71 (2003) (analyzing claim that Maine’s prescription drug program, Maine Rx, constituted extraterritorial state legislation prohibited by the dormant Commerce Clause).

<sup>94</sup> Regan, *supra* note 82, at 1887.

<sup>95</sup> See *id.* at 1888–89. Regan’s example involves an extraterritorial state law prohibiting gay sodomy, a law that would now be unconstitutional under *Lawrence v. Texas*, 123 S. Ct. 2472 (2003), independent of any extraterritoriality concerns.

<sup>96</sup> See VT. STAT. ANN. tit. 15 §§ 1202–1207 (2002).

<sup>97</sup> See Pam Belluck, *The Gay-Marriage Debate Resumes in Massachusetts*, N.Y. TIMES, March 12, 2004, at A12.

<sup>98</sup> See Sarah Kershaw, *Adversaries on Gay Rights Vow State-by-State Fight*, N.Y. TIMES, July 6, 2003, at A8.

<sup>99</sup> See Regan, *supra* note 82, at 1888.

more fundamental. As the Court reasoned in *Healy*—without any direct reference to the Commerce Clause—“any attempt “directly” to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the *inherent limits* of the State’s power.”<sup>100</sup>

Regan has argued that the prohibition on extraterritorial state legislation is not grounded in any particular provision in the Constitution’s text. Instead, it is “one of those foundational principles of our federalism which we infer from the structure of the Constitution as a whole.”<sup>101</sup> I tend to agree. It seems analogous to the principle recognized in *McCulloch v. Maryland*<sup>102</sup> that prohibits states from singling out the instrumentalities of the federal government for taxation, a limitation necessitated by the structure of our federal system.<sup>103</sup> It seems plausible, however, that extraterritorial state laws might also violate the norms of fundamental fairness protected by the Due Process Clause of the Fourteenth Amendment.<sup>104</sup> Indeed, the Court in several cases has invalidated extraterritorial state laws on due process grounds.<sup>105</sup> In any event, the prohibition on extraterritoriality probably should *not* be grounded in the Commerce Clause. While an extraterritorial state law might violate the dormant Commerce Clause by discriminating against or unduly burdening interstate commerce, it should not be understood as violating the Commerce Clause simply because it is extraterritorial.

If extraterritoriality itself does not offend the Commerce Clause, it follows that the requirement of substantive tax jurisdiction does not derive from the Commerce Clause, either. A couple of examples illustrate the point. Consider the taxation of purely intrastate commercial activity. Suppose California imposed an income tax on an Oregon company that did business exclusively within Oregon. This

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<sup>100</sup> *Healy v. Beer Inst.*, 491 U.S. 324, 336 n.13 (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 643 (1982) (plurality opinion) (quoting *Shaffer v. Heitner*, 433 U.S. 186, 197 (1977)))(emphasis added).

<sup>101</sup> Regan, *supra* note 82, at 1885.

<sup>102</sup> 17 U.S. (4 Wheat.) 316 (1819).

<sup>103</sup> See JOHN HART ELY, *DEMOCRACY AND DISTRUST* 85–86 (1980).

<sup>104</sup> *But see* Regan, *supra* note 82, at 1889–92 (arguing that extraterritorial state legislation does not violate the Due Process Clause).

<sup>105</sup> See, e.g., *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 818–21 (1985); *Hartford Accident & Indem. Co. v. Delta & Pine Land Co.*, 292 U.S. 143, 149 (1934). The Court’s more recent decisions concerning punitive damages—*BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996), and *State Farm Mutual Automobile Insurance v. Campbell*, 123 S. Ct. 1513 (2003)—also appear to be grounded in the Due Process Clause.

would plainly be unconstitutional, just like the Nebraska law prohibiting gay civil unions between Vermonters in Vermont; California would lack the requisite substantive jurisdiction to impose the tax. But the absence of nexus between California and the income it sought to tax would not, in itself, violate the dormant Commerce Clause. The dormant Commerce Clause would be inapposite, as the tax is not imposed on a firm engaged in interstate commerce. Instead, the tax would be unconstitutional simply because it taxed extraterritorial values—because it projected California’s legislative authority beyond its borders.

Or consider a state tax imposed on completely noncommercial activity. Suppose California imposed a tax on the possession of a gun in a school zone in Texas. We know from *United States v. Lopez* that the possession of a gun in a school zone does not substantially affect interstate commerce; in fact, it “has nothing to do with ‘commerce’ or any sort of economic enterprise, however broadly one might define those terms.”<sup>106</sup> Thus, a state tax on such activity would not be subject to dormant Commerce Clause scrutiny.<sup>107</sup> Yet California would clearly lack the substantive jurisdiction necessary to impose such a tax. It would amount to an “assert[ion of] extraterritorial jurisdiction over persons or property” in other states, and thus “exceed the *inherent limits* of the State’s power.”<sup>108</sup>

This understanding of the constitutional basis for the substantive jurisdiction requirement is reinforced by some of the Supreme Court’s earliest decisions addressing the breadth of states’ taxing authority. In a handful of opinions from the middle nineteenth century, the Court invalidated state taxes that operated extraterritorially without any reference to the dormant Commerce Clause. Instead, the Court simply found the taxes to be *ultra vires*, beyond the states’ legislative powers. Consider the Court’s 1854 decision in *Hays v. Pacific Mail Steamship Co.*,<sup>109</sup> handed down thirteen years before the Court first

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<sup>106</sup> 514 U.S. 459, 561 (1995).

<sup>107</sup> See *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 574 (1997) (holding that “[t]he definition of ‘commerce’ is the same when relied on to strike down or restrict state legislation as when relied on to support some exertion of federal control or regulation”) (quoting *Hughes v. Oklahoma*, 441 U.S. 322, 326 n.2 (1979)).

<sup>108</sup> *Healy v. Beer Inst.*, 491 U.S. 324, 336 n.13 (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 643 (1982) (plurality opinion) (quoting *Shaffer v. Heitner*, 433 U.S. 186, 197 (1977))) (emphasis added).

<sup>109</sup> 58 U.S. (17 How.) 596 (1854).

invalidated a state tax on Commerce Clause grounds<sup>110</sup> and fourteen years before the ratification of the Fourteenth Amendment. The taxpayer, a New York corporation, owned steamships that had their home port in New York but which spent a few weeks each year in California, in the ports of San Francisco and Benicia.<sup>111</sup> California imposed a property tax on the vessels based on these visits to California.<sup>112</sup> The Court held that New York was the tax situs of the ships, and therefore no other state could tax them as property.<sup>113</sup> Without any citation to the Commerce Clause, the Court stated simply that “the State of California had no jurisdiction over these vessels for the purpose of taxation.”<sup>114</sup>

The Court used similar reasoning in its 1870 decision of *St. Louis v. Ferry Co.*<sup>115</sup> St. Louis had imposed a tax on the taxpayer’s ferry boats, which traversed the Mississippi River between Illinois and Missouri.<sup>116</sup> In analyzing the taxpayer’s claim, the Court spoke exclusively in terms of the inherent limits on a state’s legislative jurisdiction, without any reference to the Commerce Clause:

The [state tax] authority extends over all persons and property within the sphere of its territorial jurisdiction. . . . Where there is jurisdiction neither as to person nor property, the imposition of a tax would be *ultra vires* and void. If the legislature of a State should enact that the citizens or property of another State or country should be taxed in the same manner as the persons and property within its own limits and subject to its authority, or in any other manner whatsoever, such a law would be as much a nullity as if in conflict with the most explicit constitutional inhibition. Jurisdiction is as necessary to valid legislative as to valid judicial action.<sup>117</sup>

After determining that the home port of the boats was in Illinois, the

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<sup>110</sup> The Court first struck down a state tax under the dormant Commerce Clause in *Steamship Co. v. Portwardens*, 73 U.S. (6 Wall.) 31 (1867). See 1 HELLERSTEIN & HELLERSTEIN, *supra* note 27, ¶ 4.12[2][c].

<sup>111</sup> *Hays*, 58 U.S. (17 How.) at 597.

<sup>112</sup> *Id.* at 597–98.

<sup>113</sup> *Id.* at 599–600.

<sup>114</sup> *Id.* at 599. See also 1 HELLERSTEIN & HELLERSTEIN, *supra* note 27, ¶ 4.12[2][c] (noting that the Court in *Hays* “did not refer to the Commerce Clause in its opinion”).

<sup>115</sup> 78 U.S. (11 Wall.) 423 (1870).

<sup>116</sup> *Id.* at 428–29.

<sup>117</sup> *Id.* at 429–30.

Court held that St. Louis's levy was "beyond the jurisdiction of the authorities by which the taxes were assessed."<sup>118</sup>

These decisions suggest that the Court originally recognized that the constitutional requirement that states have substantive jurisdiction over the values they seek to tax exists independent of the Commerce Clause. Of course, extraterritorial state taxes will often violate the dormant Commerce Clause. When a state projects its taxing authority into other states, it typically creates a risk of multiple taxation—that is, a risk that the same value will be taxed simultaneously by two states. If the risk of multiple taxation is attributable to the taxpayer doing business in more than one state, then it will generally violate the dormant Commerce Clause.<sup>119</sup> Such multiple taxation disadvantages firms engaged in interstate commerce relative to those doing business exclusively in one state, and thus discriminates against interstate commerce in practical effect. Indeed, the Court has explained the requirement that states have substantive tax jurisdiction in precisely these terms: "The reason the Commerce Clause includes this limit is self-evident: in a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation."<sup>120</sup>

What the Court seems to have misunderstood, though, is that it is really the consequent discrimination against interstate commerce that violates the dormant Commerce Clause, not the state's lack of nexus with the value or activity that it seeks to tax. Put differently, although extraterritorial state taxes often violate the Commerce Clause, they should not be understood to violate the Commerce Clause *because of* their extraterritoriality. To ascribe the extraterritoriality principle to

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<sup>118</sup> *Id.* at 432. Likewise, in its 1872 decision *Case of the State Tax on Foreign-Held Bonds*, 82 U.S. (15 Wall.) 300 (1872), the Court concluded that a tax was beyond a state's substantive jurisdiction based solely on the Court's conception of the inherent limits on state authority. The Court began its analysis by stating that "[t]he power of taxation, however vast in its character and searching in its extent, is necessarily limited to subjects within the jurisdiction of the State." *Id.* at 319. Relying on neither the Commerce Clause nor the Due Process Clause, the Court thus concluded that Pennsylvania's attempt to tax the bonds issued by a Pennsylvania corporation but owned by out-of-state bondholders was unconstitutional. *Id.* at 325–26. "When the property is out of the State there can then be no tax upon it for which the interest can be retained. The tax laws of Pennsylvania can have no extra-territorial operation." *Id.* at 325–26.

<sup>119</sup> See Walter Hellerstein, *State Taxation of Interstate Business: Perspective on Two Centuries of Constitutional Adjudication*, 41 TAX LAW. 37, 48–50 (1987).

<sup>120</sup> *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 777–78 (1992).



the dormant Commerce Clause is to conflate analytically distinct constitutional principles.

In short, the dormant Commerce Clause is best understood as not imposing any substantive jurisdictional requirements on the states' taxing powers. Although states must have a sufficient nexus with the values they seek to tax—they generally cannot project their taxing powers beyond their borders—this principle has its basis elsewhere in the Constitution. Perhaps it is an essential premise of our federal system; perhaps it is required by the Due Process Clause of the Fourteenth Amendment; or perhaps both are true. But attributing this nexus requirement to the dormant Commerce Clause seems both unnecessary and misconceived.

#### IV. RETHINKING ENFORCEMENT JURISDICTION

Again, in addition to substantive jurisdiction, the Supreme Court has held that the dormant Commerce Clause requires that states have enforcement jurisdiction before imposing a tax. That is, states must have a "substantial nexus" with any person or entity on which they seek to impose tax compliance obligations. And, at least with respect to the duty to collect sales or use taxes, the Court has held that this "substantial nexus" means a "physical presence" in the taxing state.<sup>121</sup> The Court's justification for ascribing this nexus requirement to the dormant Commerce Clause is that, without it, tax compliance obligations would place an "undue burden" on interstate commerce.<sup>122</sup>

The notion that state laws imposing undue burdens on interstate commerce are unconstitutional is nothing new.<sup>123</sup> For many years, the Court has held that the dormant Commerce Clause, in addition to proscribing discrimination against interstate commerce, forbids states from placing burdens on interstate commerce that are "clearly

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<sup>121</sup> See *Quill Corp. v. North Dakota*, 504 U.S. 298, 312–13 (1992).

<sup>122</sup> *Id.* at 311–13; see also Swain, *supra* note 12, at 334–36.

<sup>123</sup> See, e.g., *Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440, 443 (1960) ("Evenhanded local regulation to effectuate a legitimate local public interest is valid unless pre-empted by federal action . . . or unduly burdensome on maritime activities or interstate commerce."); *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520, 529 (1959) ("This is one of those cases—few in number—where local safety measures that are nondiscriminatory place an unconstitutional burden on interstate commerce."); *Morgan v. Virginia*, 328 U.S. 373, 377 (1946) ("[S]tate legislation is invalid if it unduly burdens that commerce in matters where uniformity is necessary—necessary in the constitutional sense of useful in accomplishing a permitted purpose.").

excessive in relation to the putative local benefits.”<sup>124</sup> Some justices have questioned the legitimacy of this doctrine’s explicit call for the judicial balancing of costs and benefits. On the present Court, for instance, Justices Scalia and Thomas believe that “[w]eighing the governmental interests of a State against the needs of interstate commerce is . . . a task squarely within the responsibility of Congress, and ‘ill suited to the judicial function.’”<sup>125</sup> For present purposes, I do not challenge the soundness of this “undue burden” analysis. Instead, my objective is to assess whether the dormant Commerce Clause, so construed, should be understood to require that states have a certain nexus with firms before imposing tax compliance obligations on them.

The first step in this inquiry is to identify the relevant burdens on interstate commerce. What exactly are the costs incurred by a firm in fulfilling state tax compliance obligations? They would seem to be the costs in learning the applicable tax laws, in accounting for the taxable events (and the states to which they are attributable), and in filing the necessary returns. These costs might be absorbed in the use of the firm’s own employees, in the hiring of outside professionals, such as lawyers and accountants, or in the acquisition of various accounting mechanisms, such as computer software. And what determines the magnitude of these costs? There seem to be six principal factors: (1) the number of states (or local governments) imposing such obligations, (2) the complexity of those states’ laws, (3) the disuniformity of those states’ laws, (4) the size of the firm on which the obligation is imposed, (5) the familiarity of the firm with the various states’ tax laws, and (6) the frequency of the firm’s taxable events occurring in a given state.

The Supreme Court has justified the dormant Commerce Clause’s enforcement jurisdiction requirement in terms of the costs attributable to the first three factors—the number of jurisdictions that

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<sup>124</sup> *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970); *see also C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 390 (1994); *Maine v. Taylor*, 477 U.S. 131, 138 (1986); *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 471 (1981); *City of Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978); *Great Atl. & Pac. Tea Co. v. Cottrell*, 424 U.S. 366, 376 (1976).

<sup>125</sup> *Bendix Autolite Corp. v. Midwesco Enters., Inc.*, 486 U.S. 888, 897 (1988) (Scalia, J., concurring in judgment) (quoting *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 95 (Scalia, J., concurring in part and concurring in judgment)) (citation omitted); *see also Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 618 (1997) (Thomas, J., dissenting) (“[O]ur negative Commerce Clause jurisprudence has taken us well beyond the invalidation of obviously discriminatory taxes on interstate commerce. We have used the Clause to make policy-laden judgments that we are ill equipped and arguably unauthorized to make.”).

could impose such obligations and the complexity and disuniformity of their tax laws. In *National Bellas Hess, Inc. v. Illinois*, for instance—the decision adopting the “physical presence” standard for jurisdiction to require the collection of use taxes, later reaffirmed in *Quill*—the Court explained that “if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes.”<sup>126</sup> This, the Court reasoned, “could entangle [a firm’s] interstate business in a virtual welter of complicated obligations,” given the “many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements.”<sup>127</sup>

The Court’s reasoning in *Quill* was essentially indistinguishable. North Dakota had attempted to require any seller that placed three or more advertisements in the state within a 12-month period to collect a use tax on sales to North Dakota customers.<sup>128</sup> The Court stated that, without this physical presence requirement,

[A] publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation’s 6,000-plus taxing jurisdictions.<sup>129</sup>

The Court then quoted parenthetically the “virtual welter of complicated obligations” language from *National Bellas Hess*.<sup>130</sup>

The problem with this logic, though, is that these are costs incurred by *all* firms engaged in interstate commerce, not just firms lacking a certain nexus with the taxing state. Put differently, the burden on interstate commerce attributable to the existence of multiple states with complex, heterogeneous taxing schemes is unrelated to a firm’s presence in the taxing state. These burdens really have nothing to do with nexus.<sup>131</sup>

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<sup>126</sup> 386 U.S. 753, 759 (1967).

<sup>127</sup> *Id.* at 759–60.

<sup>128</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 302–03 (1992).

<sup>129</sup> *Id.* at 313 n.6.

<sup>130</sup> *Id.* (quoting *Nat’l Bellas Hess*, 386 U.S. at 759–60).

<sup>131</sup> The Court alternatively justified the “substantial nexus” requirement in *Quill*—and specifically the physical presence standard for that requirement—on the

For instance, compare Barnes and Noble with Amazon.com. Barnes and Noble operates retail bookstores throughout the country, and thus has a “substantial nexus” with all fifty states under present law. In making sales at these stores, as well as by phone and over the Internet, Barnes and Noble endures all of the costs associated with multiple, complex, and disuniform state sales and use tax laws; it faces the same economic burden attributable to these factors as Amazon.com would were Amazon.com required to collect these taxes as well. In other words, the costs caused by the complexity and disuniformity of various states’ tax laws would be no greater for Amazon.com just because it lacks a physical presence in most states. Conversely, Amazon.com’s compliance costs attributable to these factors would not decrease if it chose to open a small sales office and hire a handful of employees in every state.<sup>132</sup>

Moreover, the idea that the diversity and complexity of state tax schemes would, for this reason alone, violate the dormant Commerce Clause seems inconsistent with basic principles of federalism.<sup>133</sup> As Donald Regan has explained, to suggest that there is a national interest in uniform state law “is very nearly to make nonsense of the whole idea of federal union.”<sup>134</sup> An essential “reason for having separate states is to allow diversity” in state laws,<sup>135</sup> in the field of

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ground that it established a bright-line rule that “firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes.” *Id.* at 315. The Court further noted that such “a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals.” *Id.* at 316. But this argument merely begs the relevant question. Even if we assume that a bright-line rule reduces the burden on interstate commerce caused by state tax compliance obligations, we still need some justification for the content of that rule. For instance, we might interpret the dormant Commerce Clause to forbid states from imposing tax compliance obligations on any firm with annual gross revenues under \$100 million. This would be a clear rule, but we would need some justification for the rule *other than its clarity*. We would need some explanation as to why the firm’s gross revenues (and why a level of \$100 million) form a logical basis on which to draw the bright line.

<sup>132</sup> See Swain, *supra* note 12, at 335 (“It is difficult to argue, for example, that Quill Corporation’s compliance burden would be less if it periodically sent sales representatives into the state, or had a small office in Sioux Falls.”).

<sup>133</sup> See Regan, *supra* note 82, at 1881–82; Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1177 (1986) [hereinafter Regan, *Supreme Court and State Protectionism*].

<sup>134</sup> Regan, *Supreme Court and State Protectionism*, *supra* note 133, at 1177.

<sup>135</sup> *Id.* See also Cass R. Sunstein, *Federal Appeal: Massachusetts Gets It Right*, THE NEW REPUBLIC, Dec. 22, 2003, at 21, 23 (“The genius of the federal system lies in the fact that, while requiring nationwide respect for certain rights, it allows the law to

taxation as much as any other. Unsurprisingly, then—except in this area of state tax enforcement—the Supreme Court has not considered the disuniformity of state law a dormant Commerce Clause problem other than when such disuniformity threatened to clog the physical channels of interstate commerce. For instance, in cases like *Kassel v. Consolidated Freightways Corp.*,<sup>136</sup> *Bibb v. Navajo Freight Lines, Inc.*,<sup>137</sup> and *Southern Pacific Co. v. Arizona*,<sup>138</sup> the Court invalidated state laws addressing the physical characteristics of tractor-trailer trucks and railroad cars because those laws diverged from the norms set by surrounding states. But the basis for these holdings was not the cost of complying with the divergent state laws *per se*; rather, it was the clogging effect that these outlier rules were apt to have on the physical channels of interstate transportation. Thus, nonuniformity itself has not been a Commerce Clause issue in other contexts, and there is no apparent reason to depart from that understanding with respect to state tax enforcement.<sup>139</sup>

The fourth principal factor influencing the cost of state tax compliance obligations on a given firm is the firm's size. A larger, more sophisticated firm should have the infrastructure to incur the costs of tax compliance obligations less expensively than a small firm, at least as a percentage of the firm's total revenue. But a firm's size

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adapt to the states' diverse cultures, providing extensive room for experimentation and learning.").

<sup>136</sup> 450 U.S. 662 (1981).

<sup>137</sup> 359 U.S. 520 (1959).

<sup>138</sup> 325 U.S. 761 (1945).

<sup>139</sup> Interestingly, this principle also applies to the assessment of burdens on free speech caused by diverse community standards of decency. In *Sable Communications, Inc. v. FCC*, 492 U.S. 115 (1989), for example, the Court considered the constitutionality of a federal statute that prohibited obscene telephone messages sent by "dial-a-porn" operators. The plaintiff claimed in part that the statute violated the First Amendment because it effectively required speakers to incur the costs of adjusting their messages to varying community standards of decency. See *id.* at 124–26. The Court rejected the claim, holding that the burden of complying with diverse standards was constitutionally acceptable. *Id.* at 124. "While *Sable* may be forced to incur some costs in developing and implementing a system for screening the locale of incoming calls, there is no constitutional impediment to enacting a law which may impose such costs on a medium electing to provide these messages." *Id.* at 125. Thus, although the speaker's audience might be "comprised of different communities with different local standards," the speaker "ultimately bears the burden of complying with the prohibition on obscene messages." *Id.* at 126.

*Sable* is no anomaly; the Court rejected very similar claims in *Hamling v. United States*, 418 U.S. 87 (1974), involving messages sent by mail, and *Ashcroft v. ACLU*, 535 U.S. 564 (2002), involving messages sent over the Internet.

also is unrelated to its nexus with a given state. Large firms are not necessarily more likely to have a nexus with taxing states, and small firms are not necessarily apt to be nexus-free. Nexus is, at best, a very rough proxy for presence. Amazon.com is large and sophisticated, while other firms may be small but have employees in several states. Whether a firm has a certain type of connection to the taxing state really concerns the *manner* in which a firm does business with that state's customers, not its size.<sup>140</sup>

It is only the costs associated with the last two factors—the firm's familiarity with the state's laws and the frequency of its taxable events in the taxing state—that logically support the argument that the dormant Commerce Clause should include a nexus requirement. Specifically, the greater the firm's connection to the taxing state, it seems, the more likely the firm will be familiar with the state's tax laws. And assuming the existence of economies of scale in tax compliance, the average cost of tax compliance should decline as the number of the firm's taxable events attributable to the taxing state—itsself a form of nexus—increases. Both of these factors lend some support to an enforcement jurisdiction requirement as an aspect of the dormant Commerce Clause. It seems logical to assume that, as a firm's nexus with a given state decreases, the firm's costs of tax compliance attributable to its unfamiliarity with the state's tax laws and to its limited number of taxable events in the state (with cost measured on a per event basis) would increase.

But is the magnitude of the economic burden attributable to these two factors sufficient to justify interpreting the Commerce Clause to require states to have a certain connection with a firm before imposing a tax compliance duty? The answer seems to turn on some significant empirical uncertainties. In particular, how much of the relevant economic burden depends on a firm's familiarity with the state's tax laws? To what degree do the potential efficiencies that come with economies of scale actually reduce the economic burden of state tax compliance? And how tightly do these two factors correlate with the level of a firm's presence—whether physical, economic, or otherwise—in the taxing state?

The Supreme Court did not cite any empirical evidence on these questions in either *National Bellas Hess* or *Quill*, and subsequent research does not appear to have uncovered any answers.<sup>141</sup> Further,

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<sup>140</sup> Cf. Swain, *supra* note 12, at 335 (making basically the same point with respect to physical presence).

<sup>141</sup> In contrast, empirical studies have demonstrated that the complexity and

even if we found that a significant portion of the relevant burden indeed depended on these factors, and that these costs correlated with a firm's level of nexus, could we say that the burden on firms lacking a certain nexus with the taxing state was "clearly excessive" in relation to the benefits accruing to the state from imposing its tax evenhandedly on all firms selling to its residents? This last question ultimately calls for political judgment, but without more empirical evidence, I find it difficult to say yes.

Of course, requiring states to have a certain level of nexus with those persons or entities on which they impose tax compliance obligations is perfectly sensible as a matter of *fairness*. If a firm has essentially no connection with a state, and does not purposefully direct its activities toward that state in any meaningful sense, it may be fundamentally unjust for that state to require the company to shoulder the burdens that come with tax compliance duties. The state may not have provided the firm with anything justifying the imposition, and the firm may lack fair notice that its activities would trigger the obligation. But as the Court itself explained in *Quill*, "'notice' or 'fair warning' [is] the analytic touchstone of *due process* nexus analysis."<sup>142</sup> The dormant Commerce Clause, in contrast, is "informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy."<sup>143</sup> In other words, fairness is invisible to the Commerce Clause.

We are thus left with a fairly unsatisfying rationale for requiring tax enforcement jurisdiction under the dormant Commerce Clause. The justification articulated by the Supreme Court—based on the costs associated with numerous taxing jurisdictions applying complex and disuniform tax laws—does not seem to withstand scrutiny. Nor can the increased costs of tax compliance for smaller, less sophisticated firms justify a nexus requirement, as size and nexus are largely unrelated. Instead, the soundness of the rule depends on the economic burden attributable to firms' not being especially familiar with a state's tax laws and having a limited number of taxable events

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disuniformity of state tax laws increase the costs of state tax compliance. See Sanjay Gupta & Lillian F. Mills, *Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 NAT'L TAX J. 355, 370 (2003) (concluding that "state income tax compliance costs are largely driven by complexity and disconformity"). As discussed above, however, the costs attributable to these factors do not logically justify a nexus requirement.

<sup>142</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992) (emphasis added).

<sup>143</sup> *Id.*

in the taxing state. But we simply do not know how much of the relevant burden turns on these factors, or the degree to which these factors correlate with a firm's nexus with the taxing state. In other words, the edifice of Commerce Clause nexus rests on a shaky empirical foundation.

## V. CONCLUSION

In the end, then, the case for interpreting the dormant Commerce Clause to impose a nexus requirement with respect to state taxes appears to be an uneasy one. The requirement that states have substantive jurisdiction over the values or activities they seek to tax seems more a reflection of the Constitution's general prohibition on extraterritorial state legislation than something grounded in the Commerce Clause. And the requirement that states have enforcement jurisdiction before imposing tax compliance obligations ultimately rests on some contestable empirical assumptions. This is not to say that the Constitution imposes no jurisdictional restrictions on the breadth of states' taxing authority; indeed, both the Due Process Clause and the structural premises of our federal system impose important limitations that demand a certain connection between taxing states and the firms and activities they seek to tax. Rather, the point is that it might make sense to divest these jurisdictional requirements from the dormant Commerce Clause. It might be time to discard the concept of Commerce Clause nexus.



